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Economic Report

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Commentary on Pertinent Economic Issues

Back To Basics

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When last we left the United States economy, it was in the recovery room. America's ninth postwar recession, which began in August 1990, apparently ended in spring 1991. Since then, business activity has been expanding—although at a painfully slow pace. Indeed, so slow has the turnaround been that, depending on the type and location of one's business, more than a few people find it difficult to believe that the recession is still not with us.

This is affecting attitudes, and, in turn, the economy as well. For one thing, employment levels today are further away from where they were when the economy peaked than they usually are at this point in the cycle. Obviously, this implies a tougher time finding work for those who are jobless. In turn, this is keeping people (both employed and unemployed) from spending as much as they might have at this point in the past, more than one year after the economy stopped declining.

You can see where this is affecting business strategies. The ongoing sluggishness in consumer spending, combined with the generally cautious attitude on the part of many executives, is causing many firms to try to operate with only the barest minimum of inventories. This policy apparently gives many business people a feeling of security, in that if sales should suddenly collapse, they will not be stuck with large amounts of unsold goods. Naturally, this also represents a way to save money, since goods produced must be paid for even before they are sold. The money to pay for goods that wind up on shelves is usually borrowed, so the less unsold goods, the less money must be borrowed—and the less interest expense business incurs. Not surprisingly, most bankers, who judge business activity by the demand for loans, will tell you that business remains soft.

There is no doubt in my mind that we have entered a new era—one of lowered expectations. You can deduce this from business hiring practices—which continue to be modest, at best. Many firms are apparently still smarting over the bulking up they did in the 1980s, when they added layers of management and support staff in the belief that the markets they were in would grow indefinitely—not to mention the fact that it was the trend du jour. Today's in thing among senior corporate managers is to be as lean and mean as possible and assume that markets will continue their present trend of growing only slowly—if at all. Like many trends, this, too, will not endure. However, while it prevails, it only serves to darken the mood of both businessmen and consumers, and, of course, to perpetuate today's slow-growth economy.

If the past is any guide, don't look for any sea change in people's attitudes anytime soon. In the last Economic Report, I discussed the role that human nature plays in the business cycle. People tend to try to take advantage by raising prices and/or wages, when demand for a product or service overwhelms supply; they'll do this until they've priced themselves out of the market. It usually takes a while before people realize that they've gone too far—and that goes, not only for pricing, but for other notions, such as caution when it comes to hiring, inventory accumulation, buying new machinery, etc.

Ten-Year Economic Waves

These trends last so long, they tend to be identified with entire decades. You all have heard of the Roaring Twenties. This was the decade that followed World War I, and the end of wartime restrictions on business and consumers (the Sober Decade). It brought sweeping changes to American life, as the U.S. economy entered a period of spectacular, though uneven, economic growth. Spurred by good times and a desire to be "modern," Americans adopted new attitudes and lifestyles; people moved from farms to cities in record numbers. The demand for such features of modern life as the automobile, telephone, radio and electric washing machines soared.

These good times extended to Wall Street—until the stock market crash of 1929. This sent shock waves through the financial community. Banks severely curtailed their loans to business, which, in turn, cut back production, leading to the Great Depression of the 1930s. The aftermath of the overexuberant 1920s, the 1930s saw thousands of businesses fold and millions of workers lose their jobs. Overleveraging and

Economics Department 17/270

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Economic Report

poor weather forced large numbers of farmers to abandon their farms; they moved to the cities to join the vast army of unemployed urban dwellers. In an effort to shore up domestic business, Congress passed, and President Hoover signed into law, the Smoot-Hawley Act, restricting imports. Other countries retaliated, which hurt U.S. exports, deepening our downturn.

Notwithstanding the efforts of President Roosevelt and his New Deal economic program, hard times dragged on until the advent of World War II, and the stimulus of a huge jump in military spending. The Forties were years of substantial growth. Auto plants and other factories had to be converted into defense mills for the production of planes, ships, tanks, and other weapons of war. Unemployment disappeared rapidly as men first found work in these factories, then were called up to serve in the military. Restrictions on civilian spending were imposed to free resources for the war effort. This led to pent-up demand, which, literally, exploded once the war ended. Returning veterans and their families bought products not previously available, such as new cars, refrigerators, etc.

Bolstered by labor unions, workers' buying power rose to the point where many were able to afford to buy a house, so the move to the suburbs began. Naturally, this led to a surge in construction of homes, schools, shopping centers and roads, fueling a rapid increase in jobs, hence, more growth in buying power. Unfortunately, prices jumped rapidly as well, setting the stage for the consolidation of the 1950s. Known as the Silent Generation, Americans, following the end of the Korean War, turned inward and concentrated on social reforms. The move to the suburbs slowed, and many localities began to impose restrictions on new building, leading to a slowdown in construction. A conservative economic policy cooled inflation—but at the cost of several recessions.

Every Other Decade Booms

The 1960s quickly became known as the Soaring Sixties. Pushed ahead by stimulative economic policies and by the progressive growth in military spending associated with the war in Vietnam, the U.S. economy registered its longest expansion in history—a record 106 months—between February 1961 and December 1969. Economic growth soared and the unemployment rate fell to a postwar low of just over three percent. However, the Johnson Administration's fiscal policy, which called for no increase in taxes to finance both increased military spending as well as greater outlays for domestic purposes (Guns and Butter), along with an accommodating monetary policy, laid the groundwork for the inflationary 1970s.

Dubbed by some, the Hangover Decade, the 1970s were marked by rapidly rising prices as an aftermath of the stimulative policies of the 1960s, unusually bad weather affecting the Nation's crops, a deal with the Soviet Union which tied up the country's boxcars, two freezes and four phases of price controls—and, of course, a massive jump in oil prices twice engineered by the Organization of Petroleum Exporting Countries. If these developments weren't enough to depress people, attitudes were severely battered by political scandals; both the President of the United States and the Vice President resigned within a ten-month period.

The spurt in energy prices reversed several trends of the postwar era which fueled economic growth. It caused people to turn away from the suburbs and back toward the cities, which were more energy-efficient. It also encouraged people to stop buying American cars, which were large and got poor gas mileage, and turn, instead, to foreign cars, which tended to be smaller and much more fuel efficient. And it also caused many companies to substitute labor for equipment. This was an attempt to offset the rise in energy costs—but it led to the overstaffing and poor productivity that was to characterize the 1980s.

The 1980s started out in reverse. The economy was in recession for most of the decade's first three years before responding to the stimulus provided by the Reagan Administration's Economic Recovery Tax Act of 1980 (ERTA). This is because the initial result of this program was a sharp jump in interest rates as Washington's budget deficit soared, forcing a dramatic rise in the Government's borrowing needs while the new tax law spurred borrowing by both consumers and businessmen. These high and rising interest rates attracted money from abroad, thus boosting the value of the dollar in the foreign exchange markets. By early 1985, the dollar had become so strong, it depressed our domestic manufacturing industries; U.S. exports became so costly overseas as to be uncompetitive, while foreign-made goods, by contrast, flowed into this country at a record rate because they became extremely inexpensive.

CHEMICAL BANKING
Forecast of Gross Domestic Product
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual	Projected >										
	1992				YEAR 1992		1993				YEAR 1993	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross Domestic Product	5817.5	5877.6	5956.2	6043.5	5923.7	4.4	6133.9	6219.5	6312.0	6389.4	6263.7	5.7
GDP: $87	4896.9	4924.7	4959.4	4994.6	4943.9	2.0	5032.5	5063.8	5090.1	5103.0	5072.3	2.6
% Change, Annual Rates	2.4	2.3	2.8	2.9	2.0		3.1	2.5	2.1	1.0	2.6	
Consumption $87	3314.2	3328.9	3354.1	3380.8	3344.5	2.6	3408.2	3428.6	3444.2	3458.9	3435.0	2.7
Durables $87	430.0	425.0	429.6	435.4	430.0	4.2	445.5	449.4	450.3	455.0	450.0	4.7
Non-Durables $87	1049.6	1058.2	1064.5	1075.1	1061.9	1.8	1079.8	1089.7	1084.2	1099.5	1088.3	2.5
Services $87	1834.5	1845.7	1860.0	1870.2	1852.6	2.7	1882.9	1889.5	1909.7	1904.4	1896.6	2.4
Investment $87	674.7	695.8	700.0	709.1	694.7	3.1	726.4	716.2	736.8	734.5	728.5	4.9
Non-Residential $87	507.7	497.8	505.0	510.4	505.2	-1.4	520.8	524.0	528.9	549.4	530.8	5.1
Producers Durable Equip. $87	363.4	362.9	369.5	375.3	367.8	2.6	380.7	378.6	384.1	399.9	385.8	4.9
Structures $87	144.3	134.9	135.5	135.1	137.5	-10.7	140.2	145.3	144.9	149.5	145.0	5.5
Residential $87	185.4	184.6	189.5	195.6	188.8	7.7	213.4	205.7	194.6	179.9	198.4	5.1
Inventory Changes $87	-18.4	12.7	5.4	3.1	0.7		-7.8	-13.5	13.3	5.3	-0.7	
Net Exports $87	-22.3	-34.6	-40.0	-45.5	-35.6		-44.7	-29.7	-25.6	-31.1	-32.8	
Exports $87	556.7	540.3	534.8	530.0	540.5	0.5	535.1	545.4	544.8	544.7	542.5	0.4
Imports $87	579.0	574.9	574.8	575.5	576.0	3.1	579.8	575.1	570.4	575.8	575.3	-0.1
Government Purchases $87	930.4	935.3	945.2	950.2	940.3	0.3	942.5	948.7	934.7	940.6	941.6	0.1
Federal Defense $87	267.1	264.8	259.7	254.9	261.6	-7.0	247.7	243.6	239.4	234.9	241.4	-7.7
Federal Civilian $87	105.2	110.5	115.5	120.0	112.8	9.0	119.9	124.9	120.3	125.6	122.7	8.7
State & Local $87	558.0	560.0	570.0	575.3	565.8	2.5	575.0	580.2	575.0	580.1	577.6	2.1
Final Sales: $87	4915.3	4912.0	4953.9	4991.5	4943.2	1.7	5040.3	5077.3	5076.8	5097.7	5073.0	2.6
% Change, Annual Rates	4.6	-0.3	3.5	3.1	1.7		4.0	3.0	0.0	1.7	2.6	
Domestic Demand: $87	4919.2	4959.3	4999.4	5040.1	4979.5	2.3	5077.1	5093.5	5115.7	5134.1	5105.1	2.5
% Change, Annual Rates	2.5	3.3	3.3	3.3	2.3		3.0	1.3	1.8	1.4	2.5	
GDP Price Index (1987 = 100)	118.8	119.3	120.1	121.0	119.8	2.4	121.9	122.8	124.0	125.2	123.5	3.1
% Change, Annual Rates	3.1	1.9	2.5	3.0	2.4		3.0	3.1	3.9	3.9	3.1	
Consumer Price Index (82-84 = 100)	138.8	139.7	140.7	141.8	140.2	2.9	143.0	143.9	145.1	146.4	144.6	3.1
% Change, Annual Rates	3.1	2.6	2.8	3.2	2.9		3.4	2.8	3.1	3.6	3.1	
Total Personal Income	4956.2	4972.1	5033.7	5106.5	5017.1	3.8	5200.0	5271.9	5333.4	5396.4	5300.4	5.6
Disposable Personal Income	4345.1	4375.2	4427.5	4471.7	4404.9	4.4	4545.2	4607.0	4660.0	4714.4	4631.6	5.1
Savings Rate	4.9	5.0	4.7	4.0	4.6		3.9	3.9	3.7	3.6	3.8	
Unemployment Rate	7.2	7.2	7.0	6.8	7.1		6.8	6.7	6.8	7.0	6.8	
Indus. Production (1987 = 100)	107.1	108.8	108.9	110.1	108.7	1.5	110.8	110.6	110.3	109.7	110.3	1.5
Housing Starts (000)	1260.3	1316.2	1404.5	1361.7	1335.7	31.9	1352.3	1315.9	1298.0	1140.3	1276.6	-4.4
Domestic Auto Sales (000)	6031.0	6253.5	6498.3	6435.3	6304.5	2.5	6777.9	6564.7	6393.6	6146.4	6470.7	2.6
Corporate Pre-Tax Profits	339.8	397.0	447.0	483.0	416.7	33.4	506.0	498.0	470.0	450.0	481.0	15.4
Net Profits	204.9	238.2	268.2	289.8	250.3	33.2	303.6	298.8	282.0	270.0	288.6	15.3

Source: Economics Department: June 1992

The combination of the efforts by the country's goods producers to adapt to this new era of international competition, as well as the tax laws resulting from ERTA, led to a massive restructuring of American industry—first the goods-producing sector in mid-decade, later on, the service side. The architects of this restructuring, people skilled in both finance and the tax laws, were in great demand, and, along with those who developed complex financial instruments, invested and speculated, became extremely wealthy in the process. This led some to characterize the 1980s as the Decade of Greed.

Like the 1960s, the decade of the 1980s was one of prolonged growth; it contained the second-longest (92 months) expansion in U.S. economic history. However, to some it didn't feel all that good. Many blue-collar workers lost their jobs when the country's factories restructured to meet foreign competition in mid-decade; their white-collar counterparts found themselves in the same boat as the decade's mergers, corporate takeovers, and leveraged buyouts led to sizable reductions in staff positions. The passage of the Tax Reform Act of 1986, by retroactively changing the rules for investing especially in real estate, set the stage for the collapse of the stock market in 1987, and the subsequent trimming back by Wall Street. At the same time, the major banks began to set aside reserves to cover their developing country debt; this necessitated cutbacks to replenish lost earnings.

Another byproduct of the Tax Act of 1986 was the demise of many thrifts, mainly savings and loans. This caused the regulators of commercial banks to require that they increase their capital in order to "protect" taxpayers from another S&L-type bailout. It was accompanied by admonitions not to make certain types of loans, such as to real estate developers, and for leveraged buyouts. The result—more layoffs of people working in real estate-related jobs, financial services, accounting and the law. With all of these above-average income people losing jobs that in the past appeared to be insulated from the ravages of the business cycle—not to mention the sharp drop in real estate values—it's not hard to understand why we're now in another era of consolidation, which, if the past is any guide, could last for most of this decade.

The Moderate Nineties

This explains why attitudes are so cautious—but even more important, it may well offer some important insights into the years ahead. Far more important than the percentage by which the gross domestic product expands this quarter or even this year is what the socio-economic climate will bring. In my opinion, this will have a much greater impact on Corporate America's ability to make a buck, on people's chances of finding jobs, and, as a society, on our overall sense of well being.

Apparently it takes about ten years for people's memories of the previous decade's opportunities and mistakes to fade. The implications for the business outlook go far beyond the numbers presented in the table to the left. Growth in the years ahead is likely to be slow—but so will inflation. This means no sharp swings—up or down—are likely. Less risk, maybe—but also less of an opportunity for reward.

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Commentary on Pertinent Economic Issues

A Two-Edged Sword

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There is an old expression which goes something like this: "Be careful what you wish for—your wish may come true!" For years, a number of people and policymakers have been wishing for less inflation—if not its elimination altogether. These hopes became especially fervent after our bouts with double-digit inflation in the mid-1970s, and again, towards the end of that decade and the first couple of years of the 1980s. Indeed, the slowing and virtual elimination of inflation has been the hallmark of the Federal Reserve's monetary policy for many years.

Well, guess what? Inflation has slowed considerably from its overheated pace of ten years ago. As a matter of fact, in many sectors of the U.S. economy, inflation has not only disappeared—it has been replaced by deflation, in other words, falling prices. Now some people are beginning to wonder if less inflation is all it's cracked up to be. This is because the curbing of inflation has apparently produced a number of side-effects—not the least of which may be the difficulty that the economy is having in escaping from the clutches of recession.

Because most people have known nothing but noticeable inflation since becoming economic adults, they have made decisions in the belief that inflation would continue. Some came to this conclusion involuntarily, figuring that there was no use in fighting higher prices. Others, seeing their incomes rise with inflation, were more willing to accept it. Whatever the case, the slowing of inflation that has already occurred—not to mention what may lie ahead if Fed Chairman Alan Greenspan gets his way—calls for a re-examination of many people's beliefs, buying habits, investment and business decisions.

Both key price indexes—measuring year-over-year percentage changes in prices at the consumer and the producer, or the wholesale, levels—are posting a much slower rate of inflation today than as recently as the end of 1990, not to mention ten years ago. Without subtracting any of the so-called "volatile" components, mainly food and energy, consumer prices today are rising at a yearly rate of about three percent, while producer prices are expanding at little more than half that pace. By contrast, both measures rose at a double-digit yearly clip during the years 1979 through 1981 inclusive.

Those who have been forced to accept inflation undoubtedly have no problem with its slowing. As a matter of fact, since no one likes to pay more for anything, those who look only at this aspect of inflation are not disappointed by its curbing. However, there's more to inflation than simply what the buyer sees, and it is these other sides of inflation that warrant examination at this time.

The Other Side Of Less Inflation

Let's start with one of the more publicized reasons for today's sluggish economy—the need for consumers and business to reduce some of the debts they have taken on over the years. As you know, many companies are trying to cut expenses in order to generate the cash flow to service the debts they assumed in the 1980s, when leveraging became the strategy du jour. This has become imperative for two reasons: (1) Less inflation in general makes it difficult for individual companies to raise selling prices and reduce the burden of existing debt; (2) "Real", or inflation-adjusted long-term interest rates remain unusually high, making existing debt even more burdensome.

Cutting expenses, means, of course, cutting costs. Business costs are usually divided into those that are fixed and those that are variable. The most prominent variable cost—if not the largest—for any firm is the cost of labor. Not surprisingly, many companies have reduced their payrolls by substantial amounts—not just blue-collar employees, but white-collar staffers as well. These layoffs, well publicized as they have been, have caused great concern for many people—not just those who have lost their jobs, but the great majority who are still employed but who worry that they might be next—with the result that spending has been dampened. In turn, this had led to disappointing sales, causing yet additional layoffs—a vicious cycle.

Another reason why people aren't spending traces to the paucity of wage increases. With the reported rate of unemployment at midyear at an eight-year high, most people are in no position to ask for a raise. Indeed, many find that

Economics Department
17/270

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the period between salary hikes has been stretched out well beyond a year, effectively freezing their pay—and reducing their buying power, once even today's low rate of inflation (along with higher taxes) is taken into account. These folks will buy only what they feel they must, from the cheapest nearby outlet; they certainly oppose paying more—which, of course, impacts the sales dollars business rings up at the cash register.

And it's not just the fact that people's incomes aren't growing that's keeping them from spending. It's also that the value of most families' biggest asset—their home—is actually falling. This has not only left many households with less of a financial cushion than they might have planned on, it also has affected their attitudes, which, of course, has translated into reduced spending. Needless to say, there are more than a few families who find themselves today owing more on their house than it is worth; these folks wouldn't mind seeing inflation make a comeback.

Many People Like Inflation

Borrowers in general like inflation for several reasons. First, their loans are paid off with cheaper dollars—the longer the term of the loan, the cheaper the dollars as long as inflation continues to erode the buying power of the buck. Second, since borrowing permits one to buy something sooner than would otherwise be the case had one waited until enough money was saved to afford the purchase, a borrower is ahead in a period of inflation since buying sooner rather than later beats higher prices. Because of this, many people have not hesitated to go into debt, expecting to be bailed out by inflation; these people are the ones most squeezed by today's low-inflation environment.

Lenders also have a stake in inflation. For one thing, when it is relatively easy for companies to hike selling prices, it is also easier for them to service their debts, thus helping many a bank lending officer sleep better at night. (Of course, if these loan officers were to consider the reduced buying power of the dollars they were getting back, they might have a nightmare or two.) In addition, since most loans are made on a floating rate basis, when more inflation causes interest rates in general to rise, the rates on the banks' existing loans will rise as well.

To be sure, inflation also raises the banks' non-interest operating costs, such as salaries, office supplies and maintenance. This requires that they lend increased numbers of dollars, if they are to spread these rising costs over a larger volume. No problem, since higher rates of inflation tend to increase the demand for loans by business to finance inventories and receivables, buy new equipment, etc. Indeed, another reason for today's sluggish economy is that companies are trying to keep their inventory levels down, and are holding off investing in new machinery and equipment—not only to cut costs, but because they don't expect prices of these items to rise in the near term. Their strategies would be the exact opposite if they thought prices of these items were about to rise.

If borrowers and lenders have learned to live with inflation, what about savers? No problem, here as well, since savers have come to like inflation, too. This may strike the reader as odd, since inflation clearly erodes the buying power of existing savings. However, as any saver will attest today, the low rate of inflation has also led to low interest rates. And with interest income twice as important to personal incomes today as it was 30 years ago, many people are finding that their actual buying power is worse off because inflation is low, rather than high.

Senior citizens, in particular, are hurting. As you know, they rely almost exclusively on interest from their savings to live on. With interest rates in many cases at 30-year lows, their interest income has suffered accordingly. In addition, their Social Security benefits have been growing by progressively smaller annual increments as the rate of inflation has come down. Meanwhile, their expenses—especially health care—continue to mount.

Besides Social Security recipients, many other people's incomes are linked, or indexed, to inflation. These include retired government workers, those receiving food stamps and disability payments, and those who are on the receiving end of Washington's many entitlement programs. Indeed, according to recent estimates, about one-third of all government outlays goes to programs whose benefits are indexed to the rate of inflation. Clearly, since they keep up with it, these people are at the very least indifferent to inflation.

Of course, indexing is widespread in the private sector as well. Indeed, it was a labor union in the private sector, the United Auto Workers, which in 1948 negotiated the first labor contract that included a cost-of-living adjustment (COLA). These COLA clauses were slow to catch on, but by 1965 more than a quarter of all

unionized employees were covered by such agreements; the percentage climbed to nearly 60 percent by the mid-1980s, before falling back to 29 percent today.

Non-union workers used to keep up with inflation, too. Either because of the COLAs union workers would receive, or because of the general awareness of inflation, those who didn't get automatic adjustments in their pay tended to receive raises linked to inflation informally. Many white-collar workers got used to receiving a cost-of-living adjustment at least annually; they are now smarting from its absence.

Getting back to the business side, inflation tends to help management in many ways. For one thing, it allows companies to raise their prices without fear of losing customers, since people are more likely to accept higher prices in an inflationary environment than when prices are more stable. Naturally, inflation boosts the dollar value of sales. In addition, many businessmen look to inflation as a cushion, enabling them to pass along increases in costs more readily in an inflationary environment than in an era of price stability. The net result: Inflationary times tend to boost profits, thus the compensation of corporate managers.

Certainly real estate developers must be longing for inflation. As a matter of fact, with this sector's price deflation of the past few years, most folks involved in real estate would probably settle for "flation" (price stability). Landlords have long inserted COLA clauses in their leases, while buying properties with only the smallest of down payments and the longest of mortgages. Inflation has obviously enabled these people to service their debts; deflation clearly has made it more problematic.

Elected Officials Need Inflation

One group with a major interest in inflation is elected officials. Let's start with the notion that many people equate inflation with prosperity and deflation with bad times—a not unreasonable thought in today's low-inflation, but depressed economy. At the end of the Second World War, the greatest fear was that, without the stimulus of wartime spending, the U.S. economy would lapse back into depression. But as the end of wartime controls permitted companies to raise prices (and labor to obtain wage increases), the electorate began to feel better—even though inflation had flared up. The line of reasoning at the time was that inflation could occur only if the economy were strong enough to permit business to raise prices, and it was the economy's strength that was most important to people. Sound familiar? It must, to those running for elective office this year, since many proposals coming from both the White House and the Congress would wind up boosting inflation (and presumably confidence) as well.

At another level, consider that inflation increases tax revenues for all governments. Incomes tend to be boosted by inflation, which lifts tax revenues from this source; sales and property tax collections will rise for similar reasons. More revenues, of course, mean more money is available to be spent on the politicians' constituents (and even to help balance budgets).

Now that we've examined the other side of inflation, the question is whether people will really want to stay the course, and support a policy of low—indeed, even lower—inflation. It's pretty clear that those who did more than simply accept high inflation—by betting on its continuance—are suffering the most. Real estate developers come to mind, but any individual or company that took on a lot of debt is also being squeezed. This is hurting the economy, as I have already demonstrated. On the other hand, those who did not believe that inflation would slow and failed to lock in the higher interest rates of the early and mid-1980s are unhappy, too. One might even add that the President's chances of being re-elected have also been affected by today's low inflation environment.

Will The Fed Keep Inflation Down?

Since inflation, in the final analysis, is a monetary phenomenon, the answer to the question about staying the course must ultimately come from the Federal Reserve. On the surface, the Fed appears to be determined to lick inflation—or at least reduce it to the point where it no longer is part of people's decisions to buy, sell or invest. This would be acceptable were it not for our experiences of the past, as described above. In any event, the Fed may be saying one thing, but it is doing another. Bank reserves adjusted for reserve requirements are today growing at their fastest yearly pace in five years, the money supply (excluding certificates of deposit) is soaring, and industrial raw materials prices have shot up nearly nine percent since February. Unless the Fed reverses course, generalized inflation will return—accommodating perhaps even more people's wishes in the process.

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Commentary on Pertinent Economic Issues

Prescription For Prosperity

Irwin L. Kellner
Chief Economist

While President Bush and Governor Clinton vie for the Presidency, the rest of the country is battling to extricate itself from one of the slowest three-year periods of economic growth since the 1930s. Indeed, growth is so slow as to be nonexistent in a number of industries in some regions of the United States. What is more, instead of creating jobs, the recovery is so weak that it is causing many companies to shed workers, thereby exacerbating the economic malaise.

On top of all this, there is a feeling outside the nation's capital that the people chosen to run this country find themselves unable to do anything to jump-start the economy. This, too, is a six-decade first: not since the 1930s has Washington been so powerless. Then, the government was too small to exert much influence over the course of economic events, even if it knew what to do—and it didn't, since taxes were raised and the money supply shrunk, when just the opposite was called for. Today, of course, the government is big enough to influence economic activity (some would say too big, but that's another story), and policymakers presumably know what to do.

Policy Levers Inoperative

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The problem is that the three levers that Washington uses to guide the economy have been used to their maximum, and are no longer operative. The government influences economic activity through monetary and fiscal policies and through changing the value of the dollar in foreign exchange markets. Let's examine each to see why Washington appears to be powerless.

Monetary policy has eased considerably since the beginning of 1989, when the Federal funds rate was 10 percent, and bank reserves were hardly growing. Today, short-term interest rates are at 30-year lows, yet consumers and business continue to pay off debt. This is because both lack confidence: people are afraid of losing their jobs, while most businessmen see only dim prospects for sales. In this environment, the Fed could push interest rates down to zero without boosting borrowing.

This could be the 1990s version of the 1930s "liquidity trap," a theory advanced by the great economist, John Maynard Keynes, who pointed out that monetary policy by itself cannot revive a weakened economy. Indeed, if anything, today's low interest rates may have produced the opposite of what the Fed intended by discouraging spending. This is because a lot of people rely on interest income: it's over 13 percent of personal incomes today, compared with only six percent back in 1960. Plainly, the sharp drop in interest rates on bank certificates of deposit, Treasury bills, etc., has cut deeply into this important source of buying power.

Another reason why the monetary lever can't be used any more stems from what the Fed has had to do in order to get rates this low. Bank reserves this year are growing at the fastest pace since 1987—11 percent annually. This has sent the basic money supply M1, as well as a broader measure, M2 minus small CDs, soaring at more than a 10 percent annual clip so far this year, leading a number of economists to express concern that, if anything, monetary policy may be too easy.

Fiscal policy is seemingly impotent as well. Washington's budget deficit is so huge, the government can't deliberately widen it by cutting taxes and/or increasing spending—two remedies that were recommended by Keynes to boost economic activity back in the 1930s, and which have been used throughout the postwar period, whenever stimulus was called for. The deficit for the government's fiscal year that ended September 30 very likely reached $340 billion. This is the biggest ever in absolute terms, and is one of the largest relative to the size of the U.S. economy since just after World War II. As a consequence, Washington's debt outstanding now amounts to $4.1 trillion—an amount that equals 70 percent of the gross national product, the most in 36 years.

Since most short-term rates are almost as low today as they were in 1960, it is pretty clear that the bond markets—where rates haven't fallen nearly as much—are deeply concerned about the size of the government's deficit, and who will buy all the paper the Treasury will have to issue. Thus any attempt to deliberately widen the deficit would probably result in a sharp runup in long-term interest rates, since it would mean even more Treasury paper coming to market.

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The government's inability to use its fiscal and monetary levers limits its freedom to alter the value of the dollar in foreign exchange markets. To depress the dollar, which would make our exports cheaper overseas while increasing the price of imported merchandise, the Fed would have to create more dollars—in other words, ease money further. But this is not practical for reasons discussed above. At the same time, the already-huge budget deficit necessitates that Washington sell some of its securities abroad, in order to avoid congestion in our domestic markets. But overseas investors will not buy Treasury securities if the dollar is falling and dollar-denominated interest rates are low. A falling dollar reduces the value of foreigners' holdings, while U.S. rates lower than elsewhere mean they could earn more by investing in other countries.

But even if it could, Washington probably wouldn't want to lower the value of the dollar any further in today's circumstances. Even after its recent bounce, the dollar is extremely undervalued against the European currencies. This has contributed to Europe's weakness, since its member countries are finding it harder and harder to sell goods to the U.S. and to other countries whose currencies move with the dollar. Then there is the confidence factor: notwithstanding our troubles, the dollar remains the backbone of the world's financial system, since most transactions are priced in dollars. And let's not forget inflation, which could arise from today's undervalued dollar, much less one whose value is even more depressed. This is another reason why bond rates remain relatively high.

Leave It To Business?

We could, of course, wait for the private sector to change course, and boost the economy. After all, even with government as big as it is, business and consumers still account for three-quarters of the gross domestic product. Eventually, companies will have to stop laying off people, and begin hiring once again. For their part, consumers at some point will have to buy that new car or house, furniture, home appliance, garment, etc. So why not wait and avoid creating any more problems than we already have by easing money, widening the deficit or cheapening the dollar?

Well, as our experience in the 1930s showed, declines have a way of feeding on themselves, and a change in course by the private sector could be a long time in coming. Meanwhile, there would remain much economic misery, which, if the past is any guide, could lead to social and political upheavals that might affect this country for years to come.

Right now, hiring seems to be the last thing on businessmen's minds. Because sales are so soft many firms are trying to cut costs by cutting their staffs. The need to reduce some of the debts they may have taken on during the 1980s could well be a factor, too. However, what may be good for the individual company has become bad for the economy as a whole, because it has resulted in virtually no growth in nonfarm payroll employment since the economy hit bottom back in the spring of 1991. By contrast, payrolls at this point in past recoveries averaged five percent bigger. Not surprisingly, consumer confidence remains low, and, when combined with people's high debts and lack of growth in buying power, has resulted in today's weak retail sales results. Needless to say, these poor sales tend to produce yet more cutbacks in employment, leading to less spending, and so on.

This vicious cycle could come to an end once debts are reduced to more comfortable levels, payrolls are so thin that normal business can't be conducted, or when prices start to rise fast enough to encourage buying rather than waiting. Regarding debts, consumers may be paying down installment debt, but, in many cases, they are replacing it with home-equity debt, which usually carries a lower interest rate that may still be deductible from their income tax liabilities. Relative to take-home pay, consumer debts in total have dropped only slightly from their recent record high.

Businesses have made more progress—but since their debts had jumped so dramatically during the 1980s, they have an even longer way to go before reaching desired levels. The amount of debt on business' books today remains 50 percent higher relative to net profits than it was two decades ago—and 2½ times as high as it was at the start of the 1980s.

Staffing appears to be closer to desired levels. Productivity gains have enabled many firms to handle increased business without increasing the size of their staffs, but others have had to lengthen the workweek, while still others have begun to hire "contract," or temporary employees. Both of these steps usually lead to increased hiring. As for inflation as a stimulus for growth, both the consumer and producer price indexes continue to reflect very little in the way of price increases—although industrial raw materials' prices have jumped by close to ten per-

cent since February. In any event, the financial markets would react negatively if inflation were to rise, sending interest rates up, and depressing the economy even more.

My Solution

I think there is a way to jump-start the economy, and the pluses of doing so far outweigh the negatives of doing something else or nothing at all. In my opinion, we face not just the one problem of a sluggish economy, but a second problem of the burgeoning budget deficit. With this in mind, two courses of action would appear to be necessary: the first, to deal with the more immediate and pressing problem of boosting economic growth, while the second is to address the longer-run issue of reducing the deficit.

Since the economy's problems are so similar to the 1930s, I think the main solution should stem from that era as well. I refer specifically to the government assuming the role of employer of last resort. In the 1930s, this took the form of the Work Projects Administration, or WPA. In the 1990s, it should involve increased public investment in the nation's roads, bridges, water and sewer systems. Our crumbling infrastructure demands repair, the need to lower costs and increase competitiveness makes it good for business, while the availability of people to do the job makes it good for the economy as well.

Such a program would have tremendous ripple effects. First, by putting people back to work, we can simultaneously address the twin problems of lack of confidence and depressed spending. Anytime an unemployed person finds a job, that person will feel better—and will spend every dollar earned and then some, addressing deferred needs. This will start the ball rolling. Then remember that it is the private sector that makes the steel, cement and wire cables that go into rebuilding the infrastructure, not government, and you get an additional lift. This will eventually lead to increased hiring, more confidence, income and spending, and so on. As for the money, it's already in the budget, in the form of the transportation bill signed last year by the President, but not yet widely disbursed to the states for a variety of reasons. Why not cut the red tape and get the money out?

The government could also cut Social Security taxes. This is the biggest tax that the average household pays, and right now it's draining considerable buying power from families who need it most. Social Security has always been pay-as-you-go, so what's the point of creating a surplus to be theoretically available for people who retire 20 years from now, at the expense of holding down economic activity today?

Washington should also repeal the luxury tax. This has turned out to be far more harmful to those who build the expensive cars, private planes and yachts, than it has been to would-be buyers. Help business overcome its lack of confidence by making it cheaper to invest in people, equipment, and even physical plant by cutting the capital gains tax and restoring the investment tax credit. These were the key provisions of the Tax Reform Act of 1986, which also hurt the real estate market, thus affecting many industries, so why not go all the way and repeal it entirely? This Act has contributed to the decline in homebuilding, according to a new study conducted under the auspices of the National Bureau of Economic Research. It has cut into new business formation, thereby stripping the economy of its main source of job growth. And, by eliminating the deductibility of consumer interest expense, probably caused much of the decline in new car sales over the past seven years.

To ensure that these strategies work, credit must flow more smoothly throughout the economy. Care should be taken that the regulatory process is not inadvertently choking off this flow of credit. Longer run, the deficit must be reduced. However, serious progress toward cutting the deficit must await faster economic growth. Like a patient needing an operation, the economy must be strong enough to take the strain of deficit reduction. When it is, the only politically acceptable way to reduce the deficit would be to freeze inflation-adjusted government spending on everything except the interest it must pay on its debt, and combine this with a value-added tax excluding food, housing and medical care, a tax on imported oil, and higher taxes on alcohol and tobacco.

As long as the economy is growing, these measures will reduce and eventually eliminate Washington's deficit over time. The deficit is so big, it's difficult to say how long it will take, but my guess is at least five to seven years, after this program is begun—and I wouldn't recommend starting it until 1994 at the earliest.

Our problems are not unsolvable. They merely require the application of some common sense, sacrifice—and political leadership. Surely in a country as great as ours, we can find these traits within ourselves and our leaders.

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